United States Court of Appeals

For the Ninth Circuit

WILBUR SECURITY COMPANY

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE

Respondent.

No. 16496

REPLY BRIEF OF PETITIONER

Appeal from the Tax Court of the United States

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MISCELLANEOUS CITATIONS

STATEMENT

Petitioner filed a timely Petition for Review with the United States Court of Appeals for the Ninth Circuit on or about the 21st day of April, 1959, praying that the Tax Court opinion reported at 31 T.C., No. 92, be reversed. Petitioner's brief was filed and the respondent's brief in answer has been filed.

INTRODUCTION

The instant proceeding involves the question of whether certain payments made by the petitioner in the taxable years involved herein represented interest, deductible as such for federal income tax purposes, or whether such advances represented dividends which are not deducted for federal income tax purposes. The ultimate decision on this point results in a finding that petitioner either does or does not owe additional taxes for the taxable years 1953, 1954 and 1955.

The Tax Court in its opinion specified ten tests used in determining the question now before this court (Petitioner's Main Brief, pages 10 and 11). In petitioner's main brief the ten tests were discussed. The petitioner in discussing these tests, and additional tests not mentioned by the Tax Court, adequately answered all of the arguments set forth in the respondent's main brief. However, a reply brief is necessary in order to correct a number of mistakes and misstatements.

Two rather important matters have been conceded in respondent's main brief. Respondent readily admits that *form,* in the instant proceeding, points to loan rather than equity invested capital, and that the petitioner was *not inadequately capitalized* during the taxable years involved herein (Respondent's Brief, page 42). These admissions cover the main points which courts usually rely upon in making a determination of loan versus equity invested capital.

PETITIONER'S ANSWER TO RESPONDENT'S STATEMENT

Respondent on page 3 of its brief presents a statement. Respondent sets out an amendment to petitioner's by-laws adopted at a special meeting of the petitioner wherein it was set out that the stockholders of petitioner could not transfer stock without transferring $800.00 per share of the amount outstanding in the then existing "special stockholders' account". Respondent asserts that this by-law adopted April 5, 1915, has never been amended, citing the opinion of the Tax Court (respondent's brief, page 8). This finding is clearly erroneous and is not supported by the facts of record. The said by-law covered only the accounts in the special stockholders' accounts which said account was paid off on June 5, 1939, (R. brief, p. 14). Further, John McPherson testified that this change in conditions rendered the said by-law inoperative (R. p. 173, 174). John K. McPherson testified that he did not know of the by-law until it was pointed out to him by the Internal Revenue Service in 1956 (R. 91, 92). The best evidence that

the by-law was not operative after 1939 is that several transfers of stock were made after that time without transferring the $800.00 per share referred to in the by-laws. (R. 89, 161) .

Respondent states at page 15 of its brief, as follows: "The notes remained in the stockholder's possession at all times and none of the nonstockholders ever saw them, although some knew of them". Petitioner does not know what portion of the record supports this statement. J. K. McPherson testified that the notes were left in the possession of noteholders (R. 86). Further, the notes were kept in the vault of the State Bank of Wilbur (R. 87). There is nothing in the record to substantiate the position that the notes remained with the petitioner and that none of the stockholders ever saw them. It is true that Grace Phillips did not have the note but knew of its existence, although this is amply explained by the relationship of Mrs. Phillips to John and J. K. McPherson (R. 142).

The respondent, page 16 of brief, states as follows: "The notes executed for 1952, on December 31, 1951, were originally issued to provide for 5% interest per annum. On November 4, 1952, the Board of Directors increased this interest rate to 6%." The facts of record show that the interest rate was changed because the directors of petitioner thought the 5% interest rate was low and that the noteholders might withdraw their funds. The additional interest was an added incentive to renew the notes as they became due at the end of that year (R. p. 96, 97).

Both the Tax Court and the respondent in brief state that Grace L. Phillips was a member of the Board of Directors of petitioner from 1941 to 1955 (R. 46, R's Brief, p. 20). This erroneous assumption is not supported by the record. Petitioner J. K. McPherson testified on this point only from memory and stated that Grace Phillips was a director if "if my memory serves me right". (R 96) The fact is that Grace Phillips was not a director of the corporation during any of the taxable years involved herein. The minutes of the directors' meetings contain no reference to Grace Phillips (See Ex. 15-0 (a), 41-00, 42-pp).

PETITIONER'S ANSWER TO RESPONDENT'S SUMMARY OF ARGUMENT

In respondent's summary of argument set out at pages 22 to 26 of its brief, the respondent, at pages 24 and 25, asserts the following, in the below order, show the payments in question constituted dividends rather than interest.

1. There was in fact no fixed maturity date.

2. So called interest payments depended upon the taxpayer's earnings; the determination of whether interest would be paid and the amounts thereof was solely in the discretion of the taxpayer's Board of Directors.

3. The notes were not paid on due dates.

4. There was no attempt to enforce payment of the notes, though due dates were annually violated.

5. The advances were unsecured.

6. The notes were in fact not negotiable because they never left the taxpayer's possession.

7. Outsiders would not have made the advances under like circumstances for an indefinite length of time, in effect, subject to the risks of the business, and the return thereof being exclusively within the discretion of the taxpayer's Board of Directors.

It is inconceivable how the respondent could argue that the notes contained no fixed maturity date, (No. 1 above). The notes were all for one year and were either reissued or renewed. Certainly the fact that the advances remained with the petitioner is no indicia of maturity date. Would the respondent assert that notes had no maturity date simply because the holders thereof choose to leave the money with the corporation, beyond the original period of the loan, on a re-issuance or renewal basis. The logic of this argument seems incredible to petitioner.

The respondent argues that the interest depended upon earnings and that the payment was in the discretion of the Board of Directors (No. 2 above). The petitioner would answer this question with another question, i.e.; Who, if not the Board of Directors, in any corporation, is charged with the payment of corporate obligations?

Respondent asserts that the notes were not paid on the due dates (No. 3 above). This is dependent upon the meaning of "payment". If respondent means cash was not issued to the noteholders and loaned back, this would be a correct statement. However, it must be remembered that

the interest was paid to the noteholders annually and that new notes were issued, or the old notes renewed each year. The law should not put taxpayers to the useless act of changing money merely for the sake of formality.

The respondent asserts that there was no attempt to enforce payment of the notes though due dates were annually violated (No. 4 above). The due dates were not violated and there is no evidence in the record to substantiate this assertion of fact. The notes were re-issued or renewed each year.

The respondent next argues that the advances were unsecured (No. 5 above). The advances were not unsecured. The noteholders had every right to enforce their obligation both against petitioner and against the corporate assets and could easily have done so if demand for payment of the notes was not promptly forthcoming. There were no prior creditors of the petitioner, nor were the petitioner's noteholders ever subrogated to the rights of any individuals or corporation.

Respondent asserts too that the notes were unnegotiable since they "never left the taxpayer's possession" (No. 6 above). The evidence clearly shows that the notes were always available to the noteholders in a safety deposit box in the bank. J. K. McPherson had his note, as did his father and mother. The noteholders could have easily negotiated their notes at any time. The notes are all in evidence, and surely it could not be argued that they did not meet all of the requirements of the Negotiable Instruments Act. Further, the respondent's assertion in this regard as-

sumes that the petitioner would not give the note to the noteholder if demand for such had been made. Clearly, this assertion would not be supported by anything in the record.

The facts in evidence clearly show that the petitioner could easily have borrowed a like sum from a bank at a lower interest rate (Exhibit 28-BB), and that the chief appraiser for the Equitable Life Assurance Society of the United States would have recommended a loan to the petitioner in excess of $500,000.00 (R. p. 112). This would dispose of petitioner's seventh argument as set forth above. In addition, the Respondent has agreed that petitioner was not inadequately capitalized in the taxable years in question (R. p. 42).

The respondent next asserts that the Tax Court was correct in not distinguishing the stockholders from the nonstockholders in determining whether the advances were contributions to capital or loans (Respondent's brief, page 25). The petitioner has covered this argument in main brief at p. 21. The Tax Court and the respondent both assert that the nonstockholders were in the same classification as preferred stockholders (R. p. 54, R's b. p. 45). This, of course, is in error. Preferred stockholders share in the increment of corporate assets and share in the distribution of those assets upon liquidation. (See American Jurisprudence, Volume 13, Para. 1378, page 1213). In the instant case, the nonstockholders would have no rights in corporate assets upon liquidation, nor share in the increment in petitioner's value. The nonstockholders had only the right to receive the

interest provided for in their notes; to collect the amount of principal at maturity date or to allow their advances to remain with the corporation if they so desired. There is no resemblance between the rights that the nonstockholders of petitioner had and rights that preferred stockholders would have in a corporation.

PETITIONER'S ANSWER TO RESPONDENT'S ARGUMENT B. 1

Respondent in brief (page 33) asserts that petitioner is relying upon *formalisms* and ignoring *substance* in the instant case. Basically, respondent urges that the only argument advanced by petitioner is that petitioner did issue notes in this case. Petitioner in its main brief relied upon much more than mere formalisms. The arguments set forth in petitioner's main brief (pages 8-23) need not be reiterated; suffice to say that respondent has failed in its brief to answer the petitioner's arguments.

It is not true, as respondent asserts (brief, page 33), that the petitioner is trying to *disguise* "the true nature of the amounts contained in the petitioner's 'bills payable account' ". It must again be reiterated that petitioner was organized in 1915 when it would have been impossible to foresee the maze of federal tax rules and regulations that it would be faced with in the taxable years involved herein. Why is it that the organizers of the petitioner as far back as 1915 characterized the amounts advanced to petitioner as loans, when there could have been no thought of the tax effect of interest versus dividends. Remember, too, that the petitioner treated the loans as such during all of

the excess profits tax years when to treat the amounts as equity invested capital would have resulted in substantial tax savings under both the World War I and World War II excess profits tax laws (R. p. 24). The respondent's use of the word "disguise" seems entirely unwarranted in the face of the facts here present.

At page 36 of its brief, respondent again asserts that the by-laws provided for an exchange of $800.00 of the old stockholder's account with each share of stock, and that the said by-law was still "in existence during the taxable years in question". This, of course, as has been pointed out by the petitioner, is not true. The $200,000.00 contained in the special stockholders' account up to 1938, was paid in 1938 and the stockholders' account was not in existence after that. The special stockholders' account was consolidated as respondent asserts, but the fact that money as such, did not change hands in the transaction does not cast a shadow on the consolidation (R. Brief, page 36). Here again it must be remembered that the consolidation took place at a time (1938) when federal income tax consequences were furtherest from the minds of the petitioner and its officials.

The respondent at page 41 of its brief states that demands for the payment of the amounts outstanding in the petitioner's bills payable account would have caused petitioner to liquidate. This, of course, is an erroneous assumption. The record in the instant case is replete with instances where the petitioner was offered loans at least equal to the amounts outstanding in its bills payable account (see page 7 of this

brief). Further, Mr. John McPherson testified quite explicitly that petitioner could have borrowed the money to pay the amounts outstanding in the bills payable account and that petitioner was offered the money at different times to do so. (R. 170). Certainly the fact that respondent readily admits petitioner was not inadequately capitalized during the taxable years here involved is ample evidence that petitioner would not have been rendered insolvent by a payment of the bills payable account. The admission as to "adequate capitalization" (Rs. b. p. 42, 43) is also conclusive proof that the noteholders had ample security for their loans, though respondent continually states that the loans were unsecured (see R. b. p. 40). Assets of over a million and one-half dollars stood behind the notes issued by the petitioner and the notes were not subordinate to other creditors, and yet the respondent continually asserts that the amounts outstanding in the bills payable account were "unsecured". Such a statement is irreconcilable with the facts of this case.

PETITIONER'S ANSWER TO RESPONDENT'S ARGUMENT B. 2

The petitioner has pointed out in its brief and elsewhere that during most of the period here involved over 50% of the amounts outstanding in petitioner's bills payable account were loans from persons who had no stock interest in the petitioner. The Tax Court and the respondent appear to apply family attrition rules to these amounts (R. 54, 55, R's B. p. 45, 46).

The Tax Court of the United States and respondent both admit that the nonstockholders did not have the right to vote nor participate in the management, yet it is stated that the nonstockholders had the same status as preferred stockholders. Petitioner has commented upon this elsewhere in brief (see page 7). It should be reiterated, however, that the nonstockholders had no rights in the assets upon liquidation and therefore had none of the rights of a stockholder. Their rights were limited to a creditor and nothing more could be read into the notes that were held. It would seem extremely inequitable to characterize amounts as equity invested capital simply because some of the creditors were related to the stockholders. The nonstockholders had absolutely no rights beyond their recovery of the principal amount, plus interest. None of the cases relied upon by the respondent are applicable to the instant set of facts.

CONCLUSION

The petitioner was organized in 1915. It has borrowed money from its stockholders and others since that time. The amounts so borrowed have always been characterized and treated as loans. The whole factual pattern is one of *loan* rather than *equity invested capital.*

The petitioner was more than adequately capitalized in the years involved herein. Notes were issued evidencing the amount of the outstanding indebtedness and interest was paid annually to the noteholders. The noteholders of petitioner were never subordinate to other creditors and petitioner could easily have borrowed the same amount

of money from outside sources. The stockholdings and noteholdings of petitioner were in no instance pro rata. In fact, during most of the period here involved over 50% of the loans to petitioner were from individuals who owned no stock interest in the petitioner and who were not entitled to any consideration from the petitioner, save the payment of interest, plus a return of the principal amount at the maturity date of the note. On many occasions the noteholders actually withdrew the amounts outstanding in the petitioner's bills payable account.

The Internal Revenue Service in 1938 investigated the petitioner upon the same contention now before this court and even in those years in the absence of formal notes gave the petitioner a clean bill of health.

Finally, the noteholders of the petitioner intended that the amount be loans and consistently treated the same as such.

The Tax Court of the United States has erred in the instant case in their holding that the amounts outstanding in the petitioner's bills payable account represented equity invested capital and not loans. The Tax Court opinion should therefore be reversed.

Respectfully submitted,

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